4-2008

Retirement Planning: Most People Don't Know How Nor Even Think About It

Knowledge@SMU

(http://knowledge.smu.edu.sg)

Retirement Planning: Most People Don't Know How Nor Even Think About It

Published: April 03, 2008 in Knowledge@SMU

Worldwide, individuals are being asked to make more of their own savings and investment decisions, especially for retirement. In the US and Europe, for example, there has been a switch from defined benefit pension plans (where the company is in charge of investing the retirement money) to defined contribution pension plans (where the employee is in charge of his or her own retirement money).

Research by Wharton insurance and risk management professor Olivia Mitchell and Singapore Management University finance professor Benedict Koh -- on cost structures of investment offerings in Singapore's Central Provident Fund -- shows, however, that people are not well-equipped to handle such investment decisions.

In Singapore, the Central Provident Fund (CPF) system is set up along the lines of a defined contribution plan. The main exception to individual responsibility for investment decisions is the traditional life insurance policy such as whole life and endowment insurance. In this case, each insurance company invests policyholders' premiums into a large "life fund" where investments are unseen by policyholders and outside their control. Singaporeans have a large part of their assets in these policies (S$78 billion). It is the second-largest investment after their homes.

In the past ten years, however, there has been a move by the Singapore government to have CPF members take a more active role in their own retirement planning and investment decisions. A key feature of those has been to encourage CPF members to invest their ordinary account balances in a wide range of unit trusts and investment-linked insurance products (ILPs). Both are similar to US mutual funds. CPF members may also invest their special account balances in a more narrow range of conservative investments, mostly bond funds and balanced funds (equities and bonds).

To some extent, this discretionary investment role of CPF members has been reduced by a new government rule which stipulates that, from April 1, 2008, the first S$20,000 in the member's ordinary account and the first $20,000 in the member's special account must remain in those accounts. That is, the member must hold the funds in the CPF-managed portfolio. Estimates are that this may reduce the investable funds of members by 50 per cent.

Earlier this year, Mitchell, who is also Executive Director of Wharton's Pension Research Council, presented a seminar in Singapore on strategies for enhancing retirement security. A key question she asks is "Are people well-equipped to handle such financial planning and investment decisions?" In general, the answer she finds is "No".

Retirement Capital

In her research Mitchell finds three categories of retirement capital: social capital such as family, community and networks; health capital including physical and mental investments to age gracefully; and financial capital which includes not only money but also "money smarts" (financial acumen). The most recent data from the US Health and Retirement Study covers the Baby Boomers (BB) born from 1948 to 1953. This survey is characterised by being more ethnically diverse, having fewer who are married, fewer with children, and more who are well-educated, compared to past generations. The new group is less likely to have used tobacco products, more likely to be obese, and less likely to go to church. Overall, the group's actual and perceived health does not seem to have improved over past cohorts.

With regard to wealth, more of the Boomers own their own business and more have larger holdings of assets – mostly because of the higher value of their homes. Based on projections, the BB group is thought to be less at risk of poverty compared to prior groups. Yet this forecast assumes housing continues to appreciate and social security will be paid. Accordingly, higher ownership of homes also means the newer pensioners are more at risk of a downturn in home prices. Most of the cohort owns little or no stock.

Financial Planning & Literacy

Mitchell's analysis also reveals that most Boomers have thought little about retirement. Only 27 per cent said they had spent a lot of time preparing for it. "In the 1990s, only half of the cohorts could identify what type of pension plan they had (defined benefit, defined contribution or hybrid) and fewer than half could identify when they would be eligible for early or normal retirement benefits" said Mitchell. "As for social security, over half of the current workers expect to become eligible for full social security benefits at younger ages than actually feasible."

This is a potential problem since the study finds that financial planning and wealth are positively related. Those who planned for retirement "hardly at all" had US$80,000 in median net worth, while those who planned "a lot" had US$202,000 in net worth. The difference is substantial. As to the question of whether planning causes wealth or vice-versa, the study found it was a one-way relation: planning causes wealth. (High wealth does not lead to greater retirement planning.)

The study also identified a strong relation between financial literacy and retirement planning. Persons who understood finances more were more likely to take charge and plan for their retirement. Financial literacy was judged on the basis of being able to answer simple financial questions including:

"If the chances of getting a disease are 10 per cent, how many people out of 1,000 would be expected to get the disease?" Answer: 100. (Percentage of people answering correctly: 84.)

"If 5 people all have the winning number in the lottery and the prize is $2 million, how much will each of them get?" Answer: $400,000. (Percentage of people answering correctly: 56.)

"Let's say you have $200 in a savings account paying 10% per year interest. How much would you have in the account at the end of two years?" Answer: $242. (Percentage of people answering correctly: 18.)

As the results indicate, financial literacy is not high. Encouragingly, the study showed that financial literacy increases with education. It also found that one reason that people fail to plan is because they are financially unsophisticated. The financially illiterate group, unfortunately, comprises much of the mature population. Half of the respondents to the survey did not know the difference between nominal and real interest rates. An even larger percentage did not know that holding a single company stock is riskier than holding of a unit trust or mutual fund.

Who Plans the Most?

The study found that the amount of planning an individual undertook depended on that person's financial literacy. People were grouped into three categories: simple planners, serious planners and committed planners. The 'serious planners' were able to answer more financial questions correctly than the 'simple planners'. The 'committed planners' answered the most correctly. An insightful finding is there seem to be large returns from even a little bit of planning. "Those who report they undertook any planning – even 'a little' – are much better off than those who said they planned 'hardly at all' said Mitchell. "In other words, undertaking even a little planning is associated with sizeable wealth holdings, while non-planners display less wealth. Planners (those who have thought a lot, some or a little about retirement) hold double the amount of wealth of non-planners (those who have thought hardly at all about retirement)."

The difference between the median wealth of the planners vs the non-planners was 20% (the planners were 20% more wealthy.) When housing wealth is taken out, the results are even more striking: planners had accumulated 32% more than non-planners. Still, housing wealth is an important way in which planners have built up their wealth. Mitchell's study shows that, on average, wealth increases by US$12,000 for each 1% increase in home prices.

In addition to planning, other important variables in determining wealth at retirement are education and race or ethnicity. Respondents with at least some college education have far more wealth than those who did not complete high school. Perhaps one explanation for the lower wealth of less educated persons is that those who are financially and politically illiterate are less likely to invest in high-return and tax-favoured assets. It would explain the relatively small investments in stock by this group, resulting in lower long-run returns. Previous studies have also shown that planning increases stock ownership. Mitchell notes, "Persons who plan are more likely to achieve their goals and to translate their intentions into actions when they develop concrete plans."

Other studies have also shown that a simple planning activity, such as writing down the specific steps they would like to take to implement a task, can greatly increase follow-through. Observes Mitchell, "These successes may explain why merely thinking about retirement can produce wide differences in retirement wealth. Moreover, even 'a little' or 'some' planning generates large wealth differences, as compared to those who did not think about retirement at all."

Automatic Asset Allocation Schemes

What are the planning options for persons who are not well-equipped to do it themselves? One solution that is increasingly popular is life-cycle or target-maturity date funds. These follow a predetermined risk guide path over time. For example, 70% of a person's investments might be allocated to equities when young. It would change to 30% at retirement. In the US, half of all retirement plans offer life-cycle funds, and surveys show that new hires prefer them. The US Pension Protection Act permits life cycle funds as the default investment.

Ironically, as Mitchell's study discovered, planning appears to encounter diminishing returns at higher wealth levels – that is, as people grow wealthier, they tend to plan less. Perhaps at very high wealth levels, households tend to feel no financial pressure. Unfortunately lack of planning can put retirement at risk.

back to top (#top)

back to top (#top)